Investing in First Time Funds: A Study of *Emerging Managers*

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Market Trends

The average first-time fund size has grown to $150MM vs an industry average of $564MM [1]

They account for almost one quarter of the funds closed, but only 7% of the capital raised [1]

Despite such impressive performance

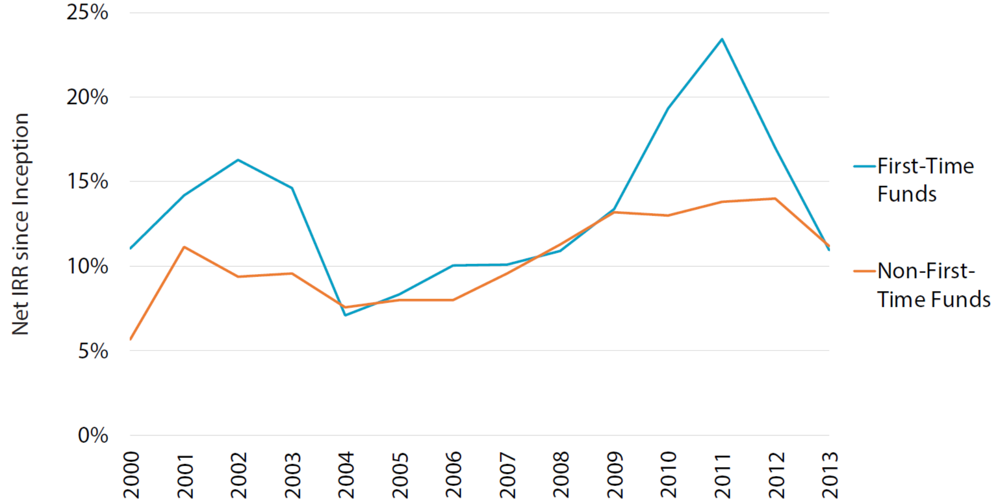
Investors have differing opinions on the risk adjusted return desirability

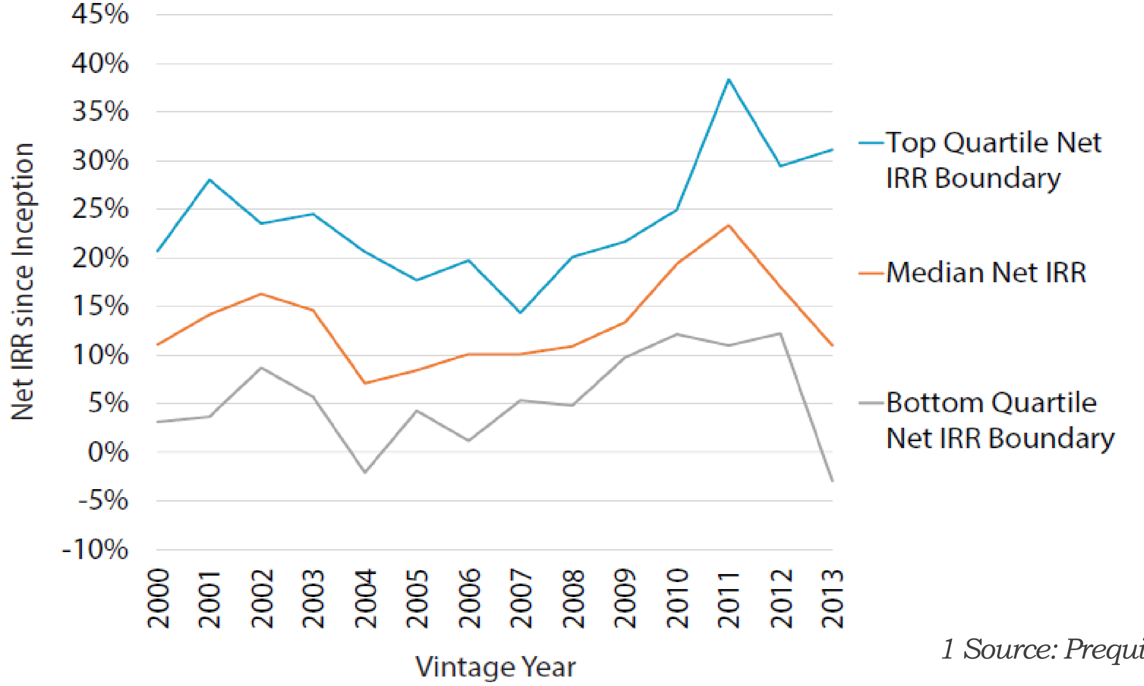
Highest total loss is still in the small cap space

The disparity between top quartile and bottom first-time funds is even wider

Median net IRRs by Vintage Year [1]

First-time vs non-first-time PE Funds





1 Source: Prequin Online

Investor Appetite in Emerging Manager

Investor appetite for first-time funds seems to be dwindling over time [1]

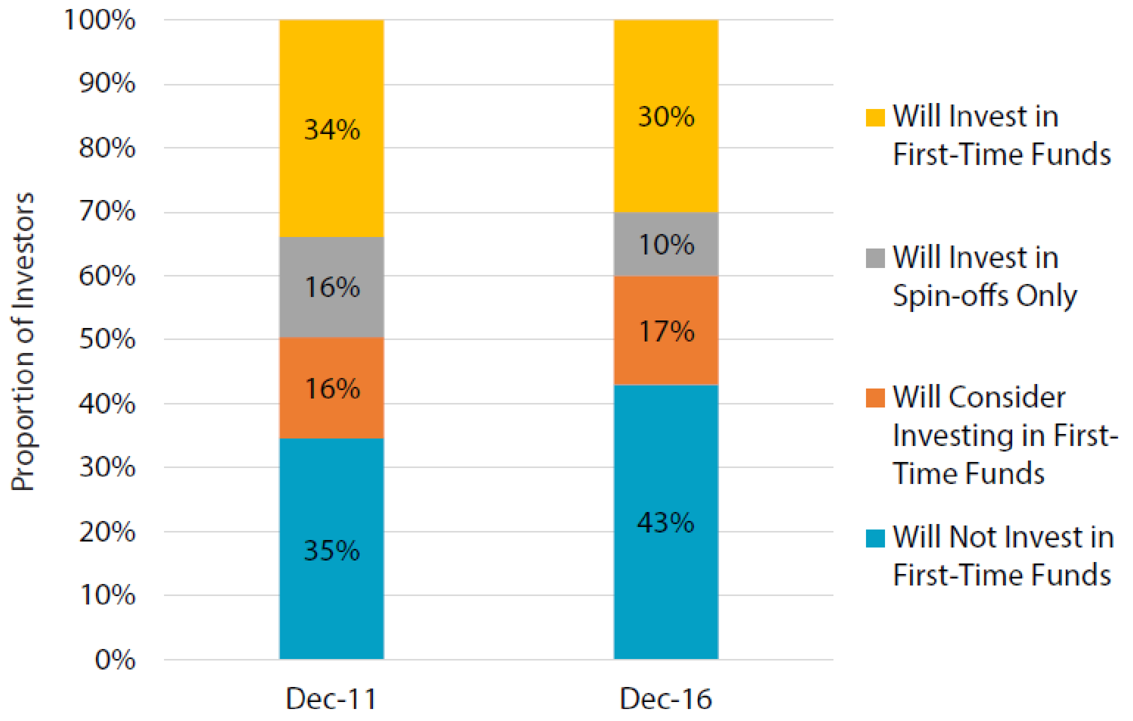
At the time of this study, there were 654 emerging managers seeking an aggregate $197 billion in capital [1]

We expect just 1/8th to be receive commitments

Certain LPs recognize both the return potential and key advantage of gaining early allocation in future great funds

Several have an "Emerging Managers Program" specifically to source, diligence, and invest in first-time funds (CalPERS, Blackstone, JP Morgan)

Investor Appetite in First-Time Funds[1]



1 Source: Prequin Online

“There is a tremendous amount of liquidity above small managers, but the area remains underserved.”

“We invest in first-time funds, but not first-time investors”

“We’re looking for an NBA team, not an NFL side.”

- LYNN BARANSKI, BLACKROCK PRIVATE EQUITY
- MORGAN HOLZAEPFEL, ADAMS STREET PARTNERS
- ED POWERS, HARBOURVEST

Interviewees

Category	Firm	Interviewee Name	PE Allocation Latest Fund $MM
Institutional Limited Partners	Blackrock Private Equity	Lynn Baranski	4,100
	J.P. Morgan	Laureen Costa T’94	25,000
	Harbourvest	Edward Power	1,600
	Old Mountain Private Trust Company	Matthew Salmon T’17	1,080
	Adams Street Partners	Morgan Holzaepfel (Webber) T’11	2,000
	Liberty Mutual	Matthew Isaacs T’19	1,000
Endowments	Harvard	John Shue	6,000
	Dartmouth	Mike Sullivan T’97, D’91	600
	Wellesley	Rose Carpenter	220
	Rockefeller	Wesley Meyer	575
Placement Agent	Monument Group	Alicia Cooney	n/a

Key Takeaways

Part I

Typical Allocations

- Most carve out specific allocations, but still limit to 2-3 allocations to first-time funds in a typical year
- There is a clear delineation between anchor investors and non-anchors
  - Large funds willing to be anchors, but if they are not – will only consider initiating conversations if a 10-20% anchor has been attached
  - Endowments typically only follow an anchor
- Anchor stake usually limited by 10% of the fund by the GP, LPs would be willing to fund 20-25% as an anchor
- Fund size must be critical size and sustainable ($100-150MM), but also larger desirable (up to $300-400MM, but sometimes up to $750MM on exception)
- Require GP to fund minimum of 2%, some take up to 10%
- Selected fund usually oversubscribed, therefore typically looking for the greatest allocation they can get in reality
- Many feel conviction weighting is irrational

Investment Thesis

- Most LPs allocate on general thematic themes
  - Invest with industry tailwinds, but avoid 'hot' sectors
- Monitor general sector trends and look for diversification across sectors and geographies, though happy being US heavy
- Will remain opportunistic outside of blackmarked sectors

Key Takeaways

Part II

Sourcing Strategies

- Maintain relationships with industry leaders and rising partners in funds already invested in - on rare occasion may even tap shoulder
- Other LPs looking to commit together, law firms, placement agents
- Boots on the ground – relevant finance and industry conferences, deal news, other events, open door policy
- Typical pipeline looks like 30-40 opportunities seriously considering, almost always through warm introductions
- Cold emails usually thrown out and not considered in sourcing pipeline
- 1 or 2 get allocation, sometimes a 3rd if exceptional (HV up to 8)

Due Diligence Process

- Very reference heavy, including many perspectives (~50 calls)
  - Colleagues
  - Portfolio company CEOs and senior management / board members
  - LP community including institutions and endowments
  - Other industry professionals
- LPs will spend a lot of time getting familiar with Emerging Managers personally
- Standard diligence checklist attached to other general fund evaluations
- Collect data and evaluate if aligns with underlying claims
- Must prove competency in fund infrastructure, structuring, people management, deal processes, business administration

Key Takeaways

Part III

Emerging Manager Profile

- Most attractive profile is a small team of 3 partners, with a proven great dynamic working together
- One sole leader is too much key man risk and less diversity of thought / effective decision-making challenging
- Like to see a wide team already being built out
- Successful and reasonably tenured career at name private equity firm, with reasons to leave (carry-related, for one)
- Legitimate background in fund focus area
- Around 40 years of age, significant career to be experienced but a future to be hungry with longevity
- Senior enough to have full responsibility for deals, but not a leader of the firm
- Team ideally has a good mix of hardened dealmakers (past i-banker types), operating experience and sector expertise
- Some place emphasis on team diversity (be it race, gender, ESG focus), however other unconcerned
- Proven leadership, people management, charismatic, visible *hunger*

Track Record

- After referencing, track record is typically most important factor, even if not strictly attributable – but exclude family office / angel
- Looking for top quartile returns, with cash realizations
- Will confirm track record and value added with GPs and CEOs
- Needs to be relatable to fund strategy

Key Takeaways

Part IV

Fundraise Status

- Most investors like to make decisions independently, therefore do not look to piggyback other LPs
- Like to see significant momentum in fundraise
- Want to see team being built out as you raise
- In the past business structure was thought of after first close, unacceptable nowadays, need to have plan in place
- Emerging managers selected are usually oversubscribed, feel this is confirmatory
- Like to give soft commitments, therefore once GP has reached critical mass of soft commitments, all LPs convert to hard commitments
- LPs expect emerging managers to have a pipeline of warm targets and several hot prospects in early LOI discussions
- In a challenging economic environment, LPs suggest raise deal-by-deal until a committed fund can be raised

Terms and Conditions

- Surprisingly, almost all LPs like to maintain market economics, regardless of opportunities to leverage position from either party
- Fee structure aligns interests well, do not want it to vary
- Restriction of GPs selling stake is attractive
- Main form of incentive / punishment is participation in subsequent funds
- Look for European waterfalls over American waterfalls
- Key man clauses also important

Checklist for A+ Emerging Manager

- Raise a fund of scale but not excessive
  - Aim for $150-300MM, $400MM if exceptional, ensure no LP is over 10% allocation
  - Standard market terms – 2and20, no GP sale, key man clause
- Have 2% GP stake ready, exceptional would be 10%
- Have an anchor in place before approach placement agent
- Attributable or semi-attributable track record from brand firm – cash returns over your career therefore likely required to be 5-10 years
- If no adequate track record, need to bring stellar reference and backer, with unique idea / opportunity that you have proprietary access to, or go deal-by-deal generating an impressive track record and proven competency
- Evidence of value-adding to portfolio CEOs who can support this message
- Team of superstars already being built out – evidence of working together effectively to achieve success
- Develop a niche investment thesis / angle – be it sector, strategy (buy-and-build etc.), operational angle, sourcing strategy, or demonstrating a unique network
- Have a pipeline of warm targets and several hot prospects in early LOI discussions
- Build a personal relationship with LPs of current firm
- Ensure you are not beholden to restrictions from current fund – either LP solicitation or attribution (less important)
- Confident can take care of administration, infrastructure, people management, general business area of the firm
- Have a business plan in place as well as the fund strategy, including team, structure, infrastructure, administration, processes, legalities / regulatory requirements

Appendix

Appendix I – Questionnaire Used

1. How do you typically assess an individual? Do you have a framework / hard rules for investment screening?
2. Do you prefer a sole leader or a team? What tenure do you expect a team to have worked together?
3. What do you look for in track record? What is acceptable as claiming as their own? What time period do you want to assess?
4. How do you balance evaluation of a potential GP? Pure past performance, investment selection , investment sourcing , investment process , network , operational expertise , charisma , technical knowledge , work experience , education , fund structure and operations , legal / regulatory / governance operations? How much weight do you give external factors such as the general market? Cyclicality / ongoing crises? Fundraising environment? Current valuation environment?
5. Do you consider the ESG perspective? Do you look for ethnic and gender diversity within the fund team? Are there any investment categories you exclude or try to avoid? How do you think about reputational risk?
6. What guides your investment thesis evaluation? Do you like generalists or want to see specialization? What areas in particular interest you? What differentiators do you typically see that interest you? What do you like to see in a pitch deck? How much prior deal information do you like to see? How much importance should a spin out GP place on this in a separation agreement with prior fund? What introductions have you found particularly compelling and why?
7. How much do you want to know about a GP's 'anti-portfolio'? What they have passed on in the past and why?
8. Do you expect the GP to have a warm target as a first investment to pitch? Or a pipeline of potential deals?
9. What size check would you be willing to write? Does it depend on fundraise target? What is the min-max target fund size you would invest in? What is your typical allocation to first time funds as a % of your latest fundraise? What is the min and max? How do you determine what level? What terms do you expect to see? What is typical versus what is the min-max for you? What are the most important terms for you outside of fee and carry (key man , co-investment , subsequent fund allocations etc.) ? What reporting requirements do you look for?
10. How do you think about discounts? Do you expect to have favourable terms if you are one of the first / largest / fastest to commit investors? Do you entertain walk-backs if certain performance criteria are hit? Or would you prefer that all investors have the same terms? Do you like to be on advisory board?
11. How much do you want to know about portfolio construction strategy? In terms of asset class , geography , risk , investment strategy , sectors? What is ideal? Do you like to see mention of SPVs from the outset?
12. What timeline do you typically see between first meeting, to signed commitment, to launch of the fund? What timeline / momentum do you like to see and how many meetings do you expect? What does your internal process look like? What is the fastest time in which you could commit?
13. How much do you consider your own portfolio construction? What is your risk tolerance? How do you go about assessing the risk-return profile of a first-time fund? Do you review and benchmark statistics? There is significant evidence that first time funds outperform non-first-time funds of similar size over the last two decades, do you pay heed to this?
14. Do you compare potential GP with others?
15. Do you like to re-invest in funds over time? How do you think about securing allocation in GPs over the long term?
16. How do you test a GP has done their homework on you?
17. How do you go about referencing a GP? Peers? Targets? Colleagues?
18. How much other external due diligence do you perform? What do your typical follow up questions look like? How much reverse diligence do you entertain (ie. GPs asking about terms / performance etc. Of other first time funds you have invested in or evaluation criteria you are using)?
19. How much weight do you put on others investing? Reputation of those other funds. Do you refer potential GPs on to other funds? Who?
20. What weighting do you put on personal fit?
21. Do you have any sourcing strategies of your own to find potential GPs?
22. Any other indicators you like to look at?

Appendix II – Next Steps

- Follow up and report back to interviewees with results – get feedback
- Keep in touch
- Identify most successful GPs – determine secret sauce